VZCZCXRO2682
RR RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHFR #0356/01 0301533
ZNR UUUUU ZZH
R 301533Z JAN 07
FM AMEMBASSY PARIS
TO RUEHC/SECSTATE WASHDC 4543
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUCNMEM/EU MEMBER STATES

UNCLAS SECTION 01 OF 02 PARIS 000356

SIPDIS

SIPDIS

PASS FEDERAL RESERVE
PASS CEA
STATE FOR EB and EUR/WE
TREASURY FOR DO/IM
TREASURY ALSO FOR DO/IMB AND DO/E WDINKELACKER
USDOC FOR 4212/MAC/EUR/OEURA

E.O. 12958: N/A
TAGS: EFIN ECON PGOV FR
SUBJECT: GOF POSTS LOWER 2006 BUDGET DEFICIT, PLANS FOR WITHHOLDING INCOME TAX

¶1. SUMMARY: France's central budget deficit decreased more than expected to 2.0 percent of GDP in 2006, prompting the government to announce that the overall budget deficit (including local government and social security budgets) would not exceed 2.6 percent of GDP. Nonetheless, the European Commission, which expects a withdrawal of excessive deficit procedures against France at the January 30 ECOFIN meeting, encouraged the government to reduce further the structural budget deficit in order to balance the budget and reduce the public debt by 2010. The announcement comes as tax policy issues move front and center in France's presidential election campaign. Center-right candidate Nicolas Sarkozy promised to reduce payroll taxes and establish a direct tax ceiling of 50% of income, while Socialist candidate Segolene Royal has commissioned former Finance Minister Dominique Strauss-Kahn to flesh out employment-friendly fiscal reform ideas that would not threaten France's generous social safety net. For its part the government has announced its intention to implement a new withholding tax in 2009. END SUMMARY.

Decline in the Central Government Budget Deficit
----------------------------------------------- ---

¶2. Budget Minister Jean-Francois Cope announced a significant decrease in the central government (CG) budget deficit in 2006, confirming that the CG budget deficit stood at 36.1 billion euros (47 billion dollars), well below the initial 42.7 billion euros (56 billion dollars) estimate. Finance Minister Thierry Breton emphasized that the government was successful in stabilizing the amount of CG budget expenditures. Expenditures decreased below the ceiling authorized by the Parliament. The improvement was also due to additional tax receipts. Receipts surpassed initial forecasts by 10.2 billion euros (13 billion dollars), including an additional 6.4 billion euros (8 billion dollars) in corporate tax receipts, 1.4 billion euros (2 billion dollars) in VAT receipts and 1.1 billion euros (1.4 billion dollars) in income tax receipts.

¶3. In an interview by financial daily Les Echos, Breton stressed that "this was the first time in 15 years that the CG budget deficit decreased to 2% of GDP." Consequently, the government will reduce issues of Treasury securities from 105 billion euros (135 billion dollars) to 102.5 billion in euros (132 billion dollars) in 2007. Breton indicated that the 2006 overall budget deficit (including CG budget, social security system and local authorities) could decrease to 2.6 percent of GDP. This is better than the recent estimate of 2.7 percent of GDP, and much better than the initial target of 2.9 percent. The government will notify the European Commission of the 2006 overall budget deficit on April 1.

European Commission Warns of Deficit after 2008
--------------------------------------------- --

¶4. The European Commission, which acknowledged that France has made progress, expects ECOFIN to put an end to the procedure for excessive deficit against France on January 30. However, the Commission warned that the French budget deficit could increase further after 2008. Balancing the budget by 2010 requires "additional effort since the structural deficit only decreased 0.3 percent of GDP between 2005 and 2007." This is below 0.5 percent, the recommendation made by the Commission given France's economic growth. The Commission deemed that the planned decrease in the public debt from 63.6 percent of GDP in 2007 to 63.3 percent in 2008 looked "slow" compared to the decrease from 66.6 percent of GDP in 2005 to 64.7 percent in 2006.

¶5. In a comment to Les Echos, Breton said "there is no reason to weaken the virtuous dynamic started two years ago by postponing this objective (a balanced budget) beyond 2010. The 2006 performance demonstrates that my program designed to balance budget accounts and to reduce the public debt by 2010 is achievable." He said economic growth was "robust," although he admitted on January 10 that the rebound in Q-4 would be weaker than expected after a disappointing drop in industrial production in November. Breton estimates GDP growth increased in a 2.4-3.2 percent (annualized) range in Q-4 2006, which should put 2006 GDP growth close to or at 2.0 percent, the bottom of the 2.0-2.5 percent range forecast by the government.

Government Prepares Withholding Tax
-----------------------------------

¶6. France has had a withholding tax for a long time, but it is only applied to dividends and interest payments, and it is optional. In recent weeks, Breton has strongly supported a withholding tax on income, saying it was his responsibility "to have everything ready" for France "to implement without delay" this reform "if the next presidential majority elected in May so wishes." He agreed with center-right candidate Nicolas Sarkozy that a withholding tax could



create confidentiality problems since employers would need to collect personal information on their employees. Breton revealed that the French tax administration has been mulling "safe and concrete" solutions, giving examples of foreign countries which have found "reliable solutions." Additional issues surrounding a withholding tax include the kinds of income that should be subject to withholding, the tax rate per family, and the financial support to companies which will suffer extra costs due to the new system.

¶7. Breton created some confusion with his announcement that the French would not pay income taxes in 2008 and would only have to start paying under the new withholding tax system beginning in 2009. Staggering the introduction of a withholding tax is needed to avoid subjecting the population to paying taxes in one year for the income earned the previous year while withholding taxes that same year for current income. Breton's announcement was immediately criticized by Socialist party leader Francois Hollande, who said "this is a trick before elections. The French will pay in 2009 what they did not pay in 2008." Hollande added "the withholding tax is a technical trick, not a reform."

¶8. Commentators emphasize the withholding tax would bring France into line with other OECD members. It would simplify tax collection, helping the government to reduce the number of civil servants. However, they say, the new system could be complex for employers, and the reduction in net incomes could make the French, who have complained about a decrease in purchasing power, feel poorer.

Tax Policy becomes Presidential Campaign Issue
----------------------------------------------

¶9. Center-right, Union for a Popular Movement (UMP) candidate Nicolas Sarkozy made taxation a campaign issue in January 2007, identifying tax policy as a way to solve the persistent problem of French unemployment. He stressed that his top priority is to restore the value of work and lift France's sluggish economic growth. He promised to reduce payroll taxes "because wages are too low, payroll taxes are too heavy, the fiscal pressure is too high." In his typically detailed fashion, he listed a number of specific

measures he would take as President. To boost consumption, he proposed cutting payroll taxes by four percent. He also proposed offering income tax incentives to employees working more than 35 hours per week. Employers would be exempt from additional payroll taxes. Sarkozy also promised to reduce the total tax ceiling from 60 percent to 50 percent of income, reduce the wealth tax for investments in small and medium-sized companies, and reduce the percentage of people subject to the individual inheritance tax. Sarkozy said he would finance tax cuts by cutting central government spending, primarily by not replacing retiring civil servants.

¶10. Center-left, Socialist Party (PS) candidate Segolene Royal denounced Sarkozy's tax proposals as "scandalous," arguing they would widen the gap between rich and poor in France. She wryly wondered if it was "really credible to promise cutting payroll taxes given the levels of the budget deficit and the public debt." Rather than detail rebutting proposals, Royal commissioned former Finance Minister Dominique Strauss-Kahn to flesh out employment-friendly fiscal reform ideas that would not threaten France's generous social safety net. In response, Breton said Royal "has no idea about taxation," and offered to publicly debate Strauss-Kahn's recommendations whenever he completes them. Some of Strauss-Khan's proposals will be incorporated in the detailed statement of policies that Royal has said she will release on February 11.

¶11. The controversy over tax policy subsequently prompted the media to investigate the wealth taxes paid by the candidates. This led to yet another (slightly more entertaining) campaign issue, but the revelations about the candidates' earnings ultimately only sharpened the budget debate.

Comment
-------

¶12. The decline in the 2006 CG budget means that the government is likely to have reached its objectives for reducing the 2006 overall budget deficit. However, achieving longer term goals will depend on more robust fiscal adjustment, notably further cuts on the expenditure side. Regardless of who wins the presidential election, this will be a political challenge. Discussion of the withholding tax, and public finances generally, may help prepare the ground for further rationalization of the French tax system going forward.

STAPLETON#